APPENDIX A

The TEXSTAR CORPORATION, Transferee of the assets of Unitex Industries, Inc. and its subsidiaries, Plaintiff-Appellee,

v.

UNITED STATES of America, Defendant-Appellant.

No. 81-1277.

United States Court of Appeals, Fifth Circuit.

Oct. 7, 1982.

Transferee of corporate assets and liabilities filed complaint seeking refund of federal income taxes allegedly improperly assessed and collected. The United States District Court for the Northern District of Texas, David O. Belew, Jr., J., 528 F.Supp. 75, entered judgment for the corporation, and the Government appealed. The Court of Appeals, Thornberry, Circuit Judge, held that corporation was not entitled to debt discount deduction based on its exchange of debentures for all outstanding preferred stock where market value of either debentures or stock could not be determined.

Reversed.

John F. Murray, Acting Asst. Atty. Gen., Michael L. Paup, William S. Estabrook, Stephen Gray, Attys., Tax Div., Dept. of Justice, Washington, D.C., for defendant-appellant.

Richard D. Walker, Fort Worth, Tex., J. Burleson Smith, J. Michael Wilkes, San Antonio, Tex., for plaintiff-appellee.

Appeals from the United States District Court for the Northern District of Texas.

Before THORNBERRY, GEE and GARWOOD, Circuit Judges.

THORNBERRY, Circuit Judge:

[1] The sole issue in this appeal is whether Texstar Corporation is entitled to a debt discount deduction under 163(a) of the Internal Revenue Code of 1954, 26 U.S.C. § 163(a),[1] based on its exchange of debenture bonds for all its outstanding preferred stock.

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1. Section 163(a) authorizes a deduction for "all interest paid or accrued within the taxable year on indebtedness." Thus, corporations commonly deduct under section 163(a) the stated interest on debentures they issue. Original-issue discount may also arise when the issuer sells a debenture for less than its face amount.

> If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond.

26 C.F.R. § 1.163-3(a)(1). This excess amount represents an additional cost to the corporation for the use of the money it is borrowing, and may be deducted as interest under § 163(a). The reasoning underlying this rule is straight-forward. If the debenture sells at less than face value, it is because its stated annual interest rate was set too low. The market effectively compensates for the difference between the interest prescribed in the bond and the prevailing market rate for money by ensuring that the bond sells at less than par. Theoretically, the difference between the face value of the bond and its selling price is equivalent to the difference between the interest actually earned by the bondholder and what he would have earned at the prevailing market rate for money. *See Commissioner of Internal Revenue v. National Alfalfa Dehydrating and Milling Co.*, 417 U.S. 134, 150, 94 S.Ct. 2129, 2138, 40 L.Ed.2d 717 (1974).

The exchange of debentures for preferred stock scrutinized in this case was carried out by Unitex Industries prior to Texstar's purchase of Unitex in 1966.[2] Unitex was first incorporated as I.C.T. Discount Corporation in 1952. At that time it issued both common and preferred stock. The preferred was cumulative, participating, no-par, non-voting stock. Each share of preferred was entitled to cumulative dividends of seventy-two cents per year prior to the payment of any dividends on common stock. And, if any dividend was paid to common shareholders, preferred shareholders were entitled to receive the same dividend per share. The articles of incorporation further provided that upon liquidation of the corporation, preferred shareholders were entitled to receive twelve dollars per share prior to any distribution on the common

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2. In 1969, Congress amended the Internal Revenue Code, setting out detailed rules governing original-issue discount in a stock-for-bonds exchange. Tax Reform Act of 1969, Pub. L. 91-172, § 413(b), 83 Stat. 611. The relevant statute now provides in pertinent part:

> In the case of a bond or other evidence of indebtedness, or an investment unit as described in this paragraph (other than a bond or other evidence of indebtedness or an investment unit issued pursuant to a plan of reorganization within the meaning of section 368(a)(1) or an insolvency reorganization . . .), which is issued for property and which—
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> (A) is part of an issue a portion of which is traded on an established securities market, or
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> (B) is issued for stock or securities which are traded on an established securities market, the issue price of such bond or other evidence of indebtedness or investment unit, as the case may be, shall be the fair market value of such property. Except in cases to which the preceding sentence applies, the issue price of a bond or other evidence of indebtedness (whether or not issued as a part of an investment unit) which is issued for property (other than money) shall be the stated redemption price at maturity.

26 U.S.C.A. § 1232(b)(2). The statute applies only to exchanges occurring after May 27, 1969. Since the debentures in this case were issued before 1969, the statute does not apply in this case.

stock with conditional participation in subsequent distributions. The preferred stock was sold door-to-door at twelve dollars per share by representatives of Jack Cage & Company. I.C.T. promised to pay the Cage Company a commission of twenty per cent of the sale price of each preferred share it sold.

I.C.T. experienced severe losses in the 1950's that resulted in a deficit in earned surplus of $4,346,857.56. In 1956, new management took charge of the corporation and began a rehabilitation program, and in 1957, I.C.T. changed its name to Unitex. The accumulated deficit nevertheless continued to make the prospect of any dividend remote. As a result, the shareholders in 1957 directed the formulation of a plan to restructure the capitalization of Unitex in a manner satisfactory to committees composed of common and preferred shareholders. Two years later, the shareholders approved a plan that eliminated the entire class of 126,023 preferred shares and gave the preferred shareholders, in exchange, two dollars in cash and a ten dollar debenture, bearing interest at the rate of five per cent per annum, for each share they returned. The plan enabled preferred shareholders to recoup the twelve dollars they had invested originally, though it required them to sacrifice their right to accrued unpaid dividends. The debentures, unlike the preferred shares, were subject to a sinking fund provision calling for the retirement of at least two and one-half per cent of the original issue of debentures each year. This exchange of preferred stock for debentures also eliminated the deficit in earnings and profits from the corporate balance sheet, improving the apparent financial condition of the company and allowing it to borrow money in the marketplace,

Id. at 79. On appeal, the government argues that the district court erred in its application of the principles set forth in *National Alfalfa* and *GM & O*. We agree.

In *National Alfalfa*, pursuant to a recapitalization plan to eliminate arrearages on preferred shares, the taxpayer corporation required its shareholders to exchange their $50 par 5% cumulative preferred shares for $50 face value 5% sinking fund debentures.[3] The taxpayer claimed a discount on the difference between the fair market value of the stock and the face amount of the debentures. After a detailed discussion of the appropriate considerations to be weighed by a court faced with this question, the Supreme Court held that the taxpayer was not entitled to bond discount. The primary inquiry in determining whether any bond discount exists is "whether the issuer-taxpayer has incurred, as a result of the transaction, some cost or expense of acquiring the use of capital." *National Alfalfa*, 417 U.S. at 147, 94 S.Ct. at 2136. The taxpayer argued that it had incurred a $17 cost in issuing the bonds because the $50 par preferred shares it received had an alleged fair market value of only $33.

The Supreme Court rejected this argument, concluding that in the absence of any actual or even attempted sales of debentures or purchases of the preferred shares by the taxpayer in the open market, the Court could only speculate as to what the market price and the investor reaction to such events would have been. *Id.* at 150, 94 S.Ct. at 2137. The Court based its refusal to speculate as to the fair market value of the bonds or the preferred shares on three grounds.

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3. A sinking fund will increase the market price of the bonds by guaranteeing that a portion of the bonds will be retired yearly. *GM & O*, 579 F.2d at 898 n. 16.

First, there was nothing in the record in *National Alfalfa* establishing the cash price at which the debentures could have been sold had they been offered for sale. Second, there was no evidence in the record to indicate that the taxpayer would have been able to purchase all its outstanding preferred on the open market, or at what price that quantity of stock would have been purchased in light of the impending exchange. The Court pointed out that the over-the-counter quotations found in the record did not reflect adequately the value per share when the entire block of preferred shares was outstanding. *Id.* at 150, 94 S.Ct. at 2138. Finally, the Court recognized that "when a corporation issues to its preferred shareholders its own new debt obligations in exchange for outstanding preferred, the claimed fair market value of both securities is somewhat artificial since the exchange is effectively insulated from market forces by the intracorporate and private nature of the transaction." *Id.* "[I]mplicit in the concept of debt discount is the assumption, and indeed the requirement, that the transaction be subject to the exigencies of the competitive money market." *Id.* at 151, 94 S.Ct. at 2138. Since the debentures in *National Alfalfa* were not traded on the open market, and since the taxpayer presented no other evidence of the fair market value of the bonds at the time of their issuance, the Court concluded that "the requisite valuation of the property to be exchanged cannot occur in this intracorporate transaction and debt discount cannot be determined." *Id.* (Citations omitted).

Four years later, this Court in *GM & O* addressed the question of original-issue discount in the context of a stock-for-bonds transaction. Between 1957 and 1962, the taxpayer in *GM & O* redeemed approximately two-thirds

of its outstanding $100 par value 5% cumulative preferred shares in exchange for an equivalent number of $100 face value 5% interest sinking fund bonds. Several years after the transaction, the taxpayer unsuccessfully applied for a tax refund based on an alleged original-issue discount computed by subtracting the total market value of the preferred during the exchange period from the total principal amount of the debentures.

Rejecting the Government's claim that *National Alfalfa* established an absolute prohibition against original-issue discount when a corporation exchanges its bonds for its own preferred stock, this Court instead applied the rule set out in *National Alfalfa* that bond discount arises only where the issuer-taxpayer incurs as a result of the transaction some costs or expense of acquiring the use of capital. 579 F.2d at 896 (citing *National Alfalfa*, 417 U.S. at 147, 94 S.Ct. at 2136). The Court concluded that the transaction in *GM & O* differed from that in *National Alfalfa* in three significant respects, and awarded the taxpayer a discount deduction measured as the difference between the principal amount of the debentures and the fair market value of the preferred stock determined by the mean New York Stock Exchange price during the exchange period.

The Court first noted that "since the original value received for the preferred shares was much less than the $100 face amount of the bonds, there was an additional cost for the use of capital." *Id.* at 898. Second, the debentures in *GM & O* were subject to a sinking fund provision while the preferred shares were not. Last, and most important, the stock-for-bonds exchange in *GM & O* "was completely voluntary and was affected by market forces."

Id. at 899. Both the preferred shares and the bonds were actively traded on the New York Stock Exchange, and their market values "could be determined by anyone with a *Wall Street Journal.*" *Id.*

[2] The same cannot be said of the present case. The debentures issued by Unitex were not traded on any market. As in *National Alfalfa,* there was nothing in the record establishing the cash price at which the debentures could have been sold had they been offered for sale. Texstar seeks to remedy this defect by arguing that since it offered one debenture plus $2 cash for each preferred share that it redeemed, the fair market value of each debenture can be calculated by subtracting $2 from the fair market value of each share of the preferred. However, none of the preferred stock was actively traded on an open market in sufficient quantity to permit the calculation of its market value. Texstar acknowledges in its brief that its own expert witness accorded little weight to the scattered quotations for the preferred on the over-the-counter market, because the market was too thin. Moreover, as in *National Alfalfa,* there is no evidence in the record to indicate that Unitex could have purchased all its outstanding preferred on the open market, or at what price that quantity of stock would have been purchased. In its denial of a discount deduction in *National Alfalfa,* the Supreme Court emphasized that the stipulated over-the-counter quotations for preferred stock "were quotations for what at most was a thin market, and were hardly representative of the fair market value of the entire 47,059 shares outstanding." 417 U.S. at 150, 94 S.Ct. at 2138.

Lacking a market value for its preferred stock, Texstar instead offers the uncontradicted testimony of its expert as

to the value of the preferred at the time of the exchange.[4] However, this value, like a published market value, cannot serve as a basis for the calculation of original-issue discount unless it can be equated with the fair market value of the debentures. This Court in *GM & O* explained that "[a]ny assumption of an equivalence of the debentures and the preferred is unjustified where the transaction is insulated from the marketplace since the market forces which normally would bring about an equivalence of the two are absent." 579 F.2d at 900 (citing *Cities Service Co. v. United States*, 522 F.2d 1281 (2d Cir. 1974), *cert. denied* 423 U.S. 827, 96 S.Ct. 43, 46 L.Ed.2d 43 (1975)). In *GM & O*, where the individual shareholders relied on published market prices for both the stocks and the bonds in deciding whether to exchange their shares, we concluded that the transaction was "influenced by the 'exigencies of the competitive money market.'" *Id.*, (citing *National Alfalfa*, 417 U.S. at 151, 94 S.Ct. at 2138). As a result, we were able in that case to identify and calculate the additional cost of borrowing incurred by the taxpayer. Market forces acted through the participants in that transaction to effectively demonstrate the existence of a readily ascertainable discount. "[I]t is economically . . . logical to assume that before deciding to trade the preferred shareholders compared the value of their stock to the value of the debentures in light of market prices and their own personal preferences." 579 F.2d at 899. In other words, if the shareholders in *GM & O* knew that one share of preferred was worth more than one debenture,

4. The basis for this estimate included those factors which the Supreme Court in *National Alfalfa* suggested were essential to a determination of the value of untraded *debentures*. Of course, where the fair market value of the debentures can be directly ascertained, any estimation of the value of the preferred is superfluous.

they would not trade. Where the shareholders would not trade until the market value of the preferred fell below the face amount of the debentures, the fair market value of the debentures could be taken as the market value of the preferred at the time of the trade. Since the corporation in *GM & O* was obligated to repay the face amount of the debentures, the difference between that figure and the fair market value of the debentures represented an added cost of borrowing. Because the debentures could have sold at par if this added cost had instead been incurred in the form of a higher stated annual rate of interest on the debentures, the added cost could be viewed as an adjustment of the interest prescribed in the debenture and the prevailing market rate for money. This cost was consequently held deductible in *GM & O* under 26 U.S.C. § 163(a) as "interest paid or accrued within the taxable year on indebtedness." Only a process like this one, that reveals the presence of discount while permitting its calculation, can justify a finding of original-issue discount in an intracorporate exchange of stock for bonds.

Nothing like this process occurred in the present case. Here, the shares were redeemed *en bloc* pursuant to a plan approved by the shareholders, as in the insulated transaction in *National Alfalfa*. Nor was the exchange entirely free, being required by charter amendment opposed by a material minority of the preferred shares.[5] The estimate of the value of the preferred sought to be substituted for the fair market value of the debentures in

5. This dilutes the force of an assumption of equivalent value in a freely agreed arms-length exchange. And to this difficulty there must be added not only the absence of a market (for both the preferred and the debentures) but also the necessarily rather speculative evidence of this particular preferred's "intrinsic" value.

this case was reconstructed many years after the transaction occurred. We are unable to perceive in this artificial scenario the play of market forces acting through informed agents to reveal a measurable additional cost of borrowing money.[6]

Since Texstar cannot change the history of this intra-corporate transaction, a remand to determine the value of either the preferred shares or the debentures would be a pointless exercise.

REVERSED.

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6. Texstar maintains that Unitex's poor financial condition just prior to the reorganization, and the two-year period during which the shareholders negotiated a reorganization plan with the corporation, furnish evidence that market forces acted on the exchange. But speculation as to the presence of general market forces "in the air" is a woefully inadequate substitute for the visible effect of the forces of supply and demand in "determin[ing] objectively how much of one [product] is worth so much of another." 579 F.2d at 892. This Court in *GM & O* held that because "the holders of preferred shares could examine the published market prices for both the preferred and the debentures before deciding to trade . . . the market value of the preferred shares is a good yardstick for determining the real issue price of the debentures." *Id.* at 900. Where, as here, no market prices were available for either the debentures or the preferred, the reconstructed market value of the preferred cannot furnish an accurate measure of the real issue price of the debentures.

We find little merit in Texstar's claim that because the original issue price of the preferred shares was less than the face amount of the debentures, the corporation suffered a measurable cost or expense of obtaining the use of capital. In determining the amount of bond discount, this Court in *GM & O* relied upon the value of the preferred shares at the time the bonds were issued, not the original value received for the stock. 579 F.2d at 901.

Although the existence of a sinking fund as an incident of the debentures may offer added protection to the debenture holders, it is relevant only to a consideration of the fair market value of the debentures themselves. Since the fair market value of the debentures cannot be directly established here, this factual distinction is of little help in the determination of debt discount.

It is not enough to hint at the existence of discount. The existence of original-issue discount is inseparable from its determination.

APPENDIX B

The TEXSTAR CORPORATION, Transferee of the assets of Unitex Industries, Inc. and its subsidiaries, Plaintiff,

v.

UNITED STATES of America, Defendant.

Civ. A. No. 4-1795.

United States District Court, N. D. Texas, Fort Worth Division.

June 29, 1981.

Transferee of assets of corporation brought suit seeking refund of federal income taxes it alleged were wrongfully assessed and collected. The District Court, Belew, J., held that where original value received for each preferred share in exchange of debentures and cash for corporation's own outstanding preferred stock was less than full amount of debentures, where only debenture holders would have advantage of a sinking fund, and moreover, market forces acted on exchange of stock for debentures, principal amount paid as premium for issuance of debenture was "original issue discount" and as such was cost or expense and under applicable section of Internal Revenue Code, deductible interest.

Order entered.

Cox, Smith, Smith, Hale, & Guenther, J. Burleson Smith and J. Michael Wilkes, San Antonio, Tex., Richard D. Walker, Fort Worth, Tex., for plaintiff.

Kenneth J. Mighell, U. S. Atty., Ben A. Douglas, Atty., Tax Division, Dept. of Justice, Dallas, Tex., for defendant.

AMENDED MEMORANDUM OPINION

BELEW, District Judge.

Plaintiff, Texstar Corporation, as transferee of assets of Unitex Industries, Inc., brings suit seeking a refund of federal income taxes it alleges wrongfully assessed and collected. This action involves original issue discount and its proper valuation.

The Court makes the following findings of fact based upon the pleadings, stipulations, and evidence elicited at the trial.[1]

1. Unitex was incorporated on August 5, 1952, as I.C.T. Discount Corporation. Its name was altered to I.C.T. Corporation on May 11, 1955, and later changed to Unitex Industries, on August 21, 1957. On November 15, 1966, the assets of Unitex Industries, Inc. were purchased by Texstar Corporation, Plaintiff, which agreed to assume any and all prior liabilities for additional federal income taxes.

2. In 1952, I.C.T. had both common and preferred stock. The preferred stock, no par value, non-callable, non-voting, was entitled to a cumulative dividend of $0.72

1. This case was tried before the Honorable Leo Brewster in August 1972. While waiting the final decision in the principal case cited herein, Judge Brewster became ill and passed away in 1979 without rendering Judgment.

per share per annum (or six (6) percent of the $12 purchase price).

3. During the period beginning January 1, 1953 and ending December 31, 1954, I.C.T. Discount Corporation had no "earnings and profits" within the meaning of that term as it is used in the Internal Revenue Code of 1954, § 316, 26 U.S.C. § 316, and no "earned surplus" as that term is defined under Texas Business Corporations Law, Tex. Bus. Corp. Act. Ann. art. 2.38 (1980). Illegal payments aggregating $1.49 per share, represented as dividends, were distributed to the preferred shareholders during that period.

4. During the early and mid-1950's, poor company management caused steep losses and resulted in a deficit in earned surplus of $4,346,857.56. In 1956, new management took charge of the corporation and began a program of rehabilitation.

5. On December 7, 1957, at a special meeting of preferred shareholders, a resolution was passed directing the management of Unitex to re-structure its capital formation. Those efforts culminated in a plan, approved by both the preferred and common shareholders, setting forth the following exchange: all present outstanding preferred stock, per share, for $2.00 cash and the issuance of a debenture, $10.00 face value, payable in twenty (20) years, bearing interest at the rate of five (5) percent per annum, with a sinking fund provision of at least two and one-half (2½) percent of the original issue debenture bonds each year, subordinated to all other debts of the company. This action was implemented in 1959, and had the effect of eliminating the deficit in earnings and profits while making a small capital surplus.

6. Plaintiff acquired the assets and assumed all liabilities of Unitex, Inc. in 1966. Subsequently, an Internal Revenue Service audit assessed deficiencies in income tax for the years 1963, ($170,484.16 plus interest of $66,393.07); 1964 ($65,307.44 plus interest of $21,514.77); 1965 ($94,443.03 plus interest of $25,446.57) and the short year January 1, 1966 through November 15, 1966 ($36,326.00 plus interest of $6,739.00). Plaintiff paid said tax on or about September 21, 1970, and later filed unsuccessful claims for refunds.

7. The parties have settled and resolved their controversy with respect to the allowance of the claimed bad debt deduction, Internal Revenue Code of 1954, § 165, 26 U.S.C. § 165, which is not related to the bond discount issue. The court hereby adopts and ratifies the parties' agreement.

8. The fair market value of Unitex preferred stock on December 31, 1959 was $3.99.[2]

Jurisdiction

Jurisdiction is founded on Title 28, U.S.C. § 1346(a)(1) (1977).

Issues of Law

I. Did an original issue discount arise upon the issuance of Unitex debentures and cash in exchange for its own outstanding preferred stock?

II. If such discount arose, what was the proper amount?

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2. See testimony of Henry Moak Rollins pages 80-84, but particularly as set out on pages 86-87 of the transcript of the trial proceedings.

Plaintiff's Complaint

Plaintiff complains Defendant has erroneously assessed and collected federal income taxes and interest thereon of three hundred twelve thousand, six hundred twenty-nine and 44/100 dollars ($312,629.44). Plaintiff characterizes the principal amount as a premium paid for the issuance of the debenture. In effect, Texstar propounds this as an original issue discount, represented by the difference between the fair market value of the Unitex stock and the stated redemption value at maturity of the debenture. As such, it is argued to be a cost or expense and under § 163 of the Internal Revenue Code, deductible interest. See Int. Rev. Code Reg. 1.163-3(a) (1968).

Defendant's Answer

The Government pictures this exchange as nothing more than a sophisticated adjustment of the corporation's capital accounts. It contends that upon original implementation of the plan, neither the corporation nor the shareholders anticipated this as an original issue discount. Rather, it was a masterful, albeit unsuccessful attempt at retroactive application of tax principles. The Government would show the intent of the parties controls; ten (10) percent is a reasonable discount rate; and under the facts and circumstances of this particular case, no bond discount existed because no new capital was acquired.

Discussion

I. This case is directly controlled by the definitional analysis of original issue discount in *Commissioner of Internal Revenue v. National Alfalfa Dehydrating and Milling Co.*, 417 U.S. 134, 94 S.Ct. 2129, 40 L.Ed.2d

717 (1974), and by the factual application of the *National Alfalfa* factors as set forth in *Gulf, Mobile and Ohio R.R. Co. v. United States*, 579 F.2d 892 (5th Cir. 1978). In an opinion by Justice Blackmun, *National Alfalfa* probes with considerable depth the constructional concept of original issue discount. It would therefore be presumptuous for this District Court to attempt any further explanation or clarification on such subject. Simply stated, debt discount generally results from the sale by an issuer of its debt obligation at an issue price below the face amount of its obligation. The difference is referred to as the discount. Internal Revenue Code of 1954, § 1232(b)(1), (2), 26 U.S.C. § 1232(b)(1), (2). This may occur whether the issuer receives cash, stock, or other property. S. Rep. No. 91-552, 91st Cong., 1st Sess. 148 (1969); H.R. Rep. No. 91-413 (Part I), 91st Cong. 1st Sess. 110 (1969); U.S. Code Cong. & Admin. News 1969, p. 1645; Steuben, *Real Estate Planning*, at 689-691 (1974).

In *National Alfalfa*, pursuant to a recapitalization plan to eliminate arrearages on preferred shares, the taxpayer corporation required its shareholders to exchange their $50.00 par value, 5% cumulative preferred shares for $50.00 face value, 5% sinking fund debentures. At the time, the preferred apparently had a fair market value of approximately $33.00. The taxpayer claimed as discount the difference between the fair market value of the stock and the face amount of the debentures. The Tenth Circuit opinion, finding a premium in fact did exist, held for the taxpayer. The Supreme Court reversed, stating as determinative, "the relevant inquiry in each case must be whether the issuer-payer had incurred as a result of the transaction(s), some cost or expense of acquiring the

use of capital,"[3] Id., 417 U.S. at 147, 94 S.Ct. at 2136.

Justice Blackmun explained the transaction in *National Alfalfa* as merely a swap of one form of investment for another, identical in each insignificant feature. The face amount of the debentures equalled the stated value of the stock; the fixed interest on the debentures was equal to the cumulative dividend on the preferred; and the sinking fund provisions for both the preferred and the debentures were comparable. The Court construed the transaction as a reshuffling of the corporation's capital structure, determined no additional cost was incurred in retaining the old capital, and concluded, ". . . the substitution by NAD [National Alfalfa Dehydrating] of its debentures for its previously outstanding preferred, without more, did not erase an obligation to pay in excess of an amount previously committed, or establish the base upon which debt discount can arise," Id., at 154, 94 S.Ct. at 2139.

Within the framework of interpreting what constitutes original issue discount as set forth by the Supreme Court in *National Alfalfa,* the Fifth Circuit in *Gulf, Mobile and Ohio R.R. Co. v. United States,* 579 F.2d 892 (1978), carved three significant distinctions which would factually distinguish its case from *National Alfalfa.* In *GM & O,* during 1956, the company issued 5% income debentures to be exchanged on a voluntary basis for up to approximately 283,000 shares of *GM & O's* outstanding preferred stock. *GM & O* would cancel the preferred stock upon an exchange of one income debenture in the principal amount of $100.00 for one share of preferred stock with

3. In *National Alfalfa,* the court additionally held on the facts no additional capital had been acquired. Therefore, the proper emphasis derived from the Supreme Court opinion should focus upon the additional *cost incurred* rather than the additional *capital acquired.*

one in *National Alfalfa*), we must then line up our facts wtih the distinguishing factors in *GM & O*. This Court finds an original issue discount foundationed upon the following: (1) the original value received for each preferred share, based on all relevant criteria, was less than the face amount of the debenture. Unitex paid a $2.40 commission on each and every share of stock sold. This effectively reduced the amount of capital realized by the taxpayer for the bond issue ($12.00 - 2.40 = $9.60). *Helvering v. Union Pac. R.R. Co.*, 293 U.S. 282, 287, 55 S.Ct. 165, 167, 79 L.Ed. 363 (1934); *GM & O*, supra, 579 F.2d at 897 n.12; *United States v. St. Louis-San Francisco Ry. Co.*, 537 F.2d 312, 316-7 (8th Cir. 1976). In accounting terms, there was net paid-in capital of $9.60 per preferred share. As such, Unitex incurred an additional cost for the use of capital in the form of a premium.

(2) As in *GM & O*, under the exchange offer to the shareholders, only debenture holders would get the advantage of a sinking fund. Apparently, as earlier set out, this was an important distinction to the Supreme Court. This benefit negated the mere substitution of one form for another that "did not create an obligation to pay in excess of an amount previously committed," *National Alfalfa*, supra, 417 U.S. at 154, 94 S.Ct. at 2139. We find it also represented an additional cost for the use of capital.

(3) Market forces acted on the exchange of stock for debentures. This last factor is critical and weighs most heavily upon the facts. Unitex had been suffering through hard times until 1957. Then, new management was installed and took charge. Great effort was made to purge

the company of any dead weight. There was some success in this movement, but stability was still years away. Any long-term investment in Unitex carried a high degree of risk. It was in this predicament the new management approached the preferred shareholders. The corporation could not reorganize without their approval. After *two years* of negotiations, an agreement was reached.[6] Each shareholder would trade one share for $2.00 cash and a $10.00 debenture, redeemable in twenty years. This was a difficult choice and was reflected by the time it took to agree. Furthermore, a promise to pay $10.00 in 1979 by Unitex was not worth $10.00 in 1959. The corporation still possessed assets, and if liquidation occurred, they could assert their priority status and recognize some return. Additionally, the debenture was unsecured and subordinated to all other debt.

[1] Under these circumstances, the preferred class voted to permit the exchange on the gamble their relatively low per-share worth would in the long-run yield a substantial gain. It is a decision investors every day make. And it is not for the Courts to judge if there was any more than adequate consideration passed. An important element in the determination of *National Alfalfa*, easily overlooked, is the issuer's *financial condition*, including both its credit position and profit prospects. Unitex was in serious difficulty. It struck some hardpressed deals in

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6. See *National Alfalfa*, supra, 417 U.S. at 151, 94 S.Ct. at 2138, where Justice Blackmun cited for comparison the District Court opinion in *GM & O v. United States*, 339 F.Supp. 489 (S.D. Ala. 1972) as well as another District Court decision from within the Fifth Circuit, *Southern Fertilizer and Chem. Co. v. Edwards*, 167 F.Supp. 879, 887 (M.D. Ga. 1955), in which discount was allowed after the parties conducted "arm's-length negotiations" to establish the amount of debentures and stock to be exchanged.

order to survive. And this distinguishes it from *National Alfalfa's* situation (a solid, going concern, attempting to expand its eastern producing areas, 417 U.S. at 138, 94 S.Ct. at 2132) or *GM & O's* (saving taxes, 579 F.2d at 894). Every transaction is different. Here, Unitex paid a premium, a high premium, in the form of interest to swing passages of the plans. Under *National Alfalfa* guidelines, the Court finds this a cost or expense to Unitex. The ultimate result of this difference was the corporation obligating itself to pay a debt greater in value than that which it received. It is irrelevant it re-claimed its own securities, because they still possessed value to the corporation. Consequently, any difference between this amount and the maturity value of the bonds should be and is treated as a discount.

[2] II. The second issue involves a computation of the deductible discount. The amount and formula is set forth below:

Step 1	$3.99(a)
	- 2.00(b)
	$1.99(c)
Step 2	$10.00(d)
	- 1.99(c)
	$ 8.01(e)

Legend:

(a) Fair market value of Unitex stock on December 31, 1959, as found by the Court.

(b) Cash given as part of exchange plan.

(c) Issue price of bond.[7]

(d) Stated redemption value of debenture at maturity.

(e) Amount of original issue discount. From a reading of *National Alfalfa*, *GM & O*, and *Cities Service*, it is this Court's determination the above represents the correct amount of the original issue discount.[8] One additional point needs to be clarified: the $2.40 as a commission. The Court finds this an underwriting cost, and consequently, irrelevant to original issue discount.

Judgment is to be entered for the Plaintiff in accordance with this opinion.

AMENDED JUDGMENT

In accordance with the Memorandum Opinion entered on this date, it is hereby ORDERED, ADJUDGED and DECREED that Plaintiff Texstar Corporation do have and recover of and from the United States of America the sum of $312,629.44, as stipulated by Plaintiff, bearing interest from September 21, 1970, as provided by law. Costs are taxed against the United States of America.

IT IS SO ORDERED.

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7. Note in *GM & O*, supra, 579 F.2d at 900, where the 5th Circuit stated "the market value of the preferred shares is a good yardstick for determining the real issue price of the debentures."

8. This Court takes note both sides have moved for a new trial on the sole issue of the fair market value of the debenture. This is a 20+ year-old case. Sensing the jury originally had some difficulty with these issues and feeling confident of its own determination, the Court adjudges nothing significantly different would result.

APPENDIX C

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NO. 81-1277

D. C. Docket No. CA-4-1795

THE TEXSTAR CORPORATION,
Transferee of the Assets of Unitex Industries, Inc.
and its Subsidiaries,
Plaintiff-Appellee,

versus

UNITED STATES OF AMERICA,
Defendant-Appellant.

Appeal from the United States District Court for the
Northern District of Texas

Before THORNBERRY, GEE and GARWOOD,
Circuit Judges.

JUDGMENT

This cause came on to be heard on the record on appeal and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, reversed;

IT IS FURTHER ORDERED that the plaintiff-appellee pay to the defendant-appellant the costs on appeal, to be taxed by the Clerk of this Court.

October 7, 1982

ISSUED AS MANDATE: Nov. 16, 1982.

APPENDIX D

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 81-1277

THE TEXSTAR CORPORATION, Transferee of the Assets of Unitex Industries, Inc. and its Subsidiaries,
Plaintiff-Appellee,

versus

UNITED STATES OF AMERICA,
Defendant-Appellant.

Appeal from the United States District Court for the Northern District of Texas

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ON PETITION FOR REHEARING

(November 4, 1982)

Before THORNBERRY, GEE AND GARWOOD, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby denied.

ENTERED FOR THE COURT:

/s/ THOMAS GIBBS GEE
United States Circuit Judge

APPENDIX E

Relevant provisions of the Tax Reform Act of 1969, the Internal Revenue Code of 1954 and the Treasury Regulations thereunder.

Tax Reform Act of 1969, § 413(e), Pub. L. No. 91-172, § 143(e), 83 Stat. 487 (1970):

> Effective Date.—The amendments made by this section shall apply with respect to bonds and other evidences of indebtedness issued after May 27, 1969 (other than evidences of indebtedness issued pursuant to a written commitment which was binding on May 27, 1969, and at all times thereafter).

I.R.C. § 163(a), 26 U.S.C. § 163(a) (1978):

> Interest
>
> (a) General rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Treas. Reg. § 1.163-3(a)(1) (1968), T.D. 6984, 1969-1 C.B. 38; 26 C.F.R. § 1.163-3(a)(1) (1982):

> (a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond (as defined in paragraph (b)(2) of § 1.1232-3).

Treas. Reg. § 1.1001-1(a) (1971), T.D. 7142, 1971-2 C.B. 295, 26 C.F.R. § 1.1001-1(a) (1982):

(a) *General rule.* Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001 (a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (*i.e.*, the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant,

or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by a transfer in trust).

I.R.C. § 1232(b)(2), 26 U.S.C. § 1232(b)(2) (1982):

(2) Issue price.—In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term "issue price" means the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such bonds or other evidences of indebtedness were sold. In the case of privately placed issues of bonds or other evidence of indebtedness, the issue price of each such bond or other evidence of indebtedness is the price paid by the first buyer of such bond increased by the amount, if any, of tax paid under section 4911, as in effect before July 1, 1974 (and not credited, refunded, or reimbursed) on the acquisition of such bond or evidence of indebtedness by the first buyer. For purposes of this paragraph, the terms "initial offering price" and "price paid by the first buyer" include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof. In the case of a bond or other evidence of indebtedness and an option or other security issued together as an investment unit, the issue price for such investment unit shall be determined in accordance with the rules stated in this paragraph. Such issue price attributable to each element of the investment unit shall be that portion thereof which the fair market value of such element bears to the total fair market value of all the elements in the investment unit. The issue price of the bond or other evidence of indebtedness included in such investment unit shall be the portion so allocated to it. In the

case of a bond or other evidence of indebtedness, or an investment unit as described in this paragraph (other than a bond or other evidence of indebtedness or an investment unit issued pursuant to a plan of reorganization within the meaning of section 368 (a)(1) or an insolvency reorganization within the meaning of section 371 or 374), which is issued for property and which—

(A) is part of an issue a portion of which is traded on an established securities market, or

(B) is issued for stock or securities which are traded on an established securities market,

the issue price of such bond or other evidence of indebtedness or investment unit, as the case may be, shall be the fair market value of such property. Except in cases to which the preceding sentence applies, the issue price of a bond or other evidence of indebtedness (whether or not issued as a part of an investment unit) which is issued for property (other than money) shall be the stated redemption price at maturity.

Treas. Reg. § 1.1232-3(b)(2)(iii) (1972), T.D. 7213, 1972-2 C.B. 482; 26 C.F.R. § 1.1232-3(b)(2)(iii) (1982):

(iii) *Issuance for property after May 27, 1969—(a) In general.* Except as provided in *(b)* of this subdivision, if an obligation or an investment unit is issued for property other than money, the issue price of such obligation shall be the stated redemption price at maturity and, therefore, no original issue discount is created as a result of the exchange. However, in such case, there may be an amount treated as interest under section 483. In the case of certain exchanges of obligations of the United States for

other such obligations, see section 1037 for the determination of the amount of original issue discount on the obligation acquired in the exchange. For carryover of original issue discount in the case of certain exchanges of obligations, see subparagraph (1)(iv) of this paragraph.

(b) Exceptions for original issue discount. If an obligation or investment unit is issued for property in an exchange which is not pursuant to a plan of reorganization referred to in *(d)* of this subdivision, and if—

(1) The obligation, investment unit, or an element of the investment unit is part of an issue a portion of which is traded on an established securities market, or

(2) The property for which such obligation or investment unit is issued is stock or securities which are traded on an established securities market,

then the issue price of the obligation or investment unit shall be the fair market value of the property for which such obligation or investment unit is issued, as determined under *(c)* of this subdivision. Such issue price shall control for purposes of determining the amount realized by the person exchanging the property for the obligation or unit issued and the bases of the property acquired by the holder and issuer.

An obligation which is not traded on an established securities market and which is not part of an issue or investment unit a portion of which is so traded shall not be treated as property described in *(1)* of this *(b)* even though the obligation is convertible into property so traded. For purposes of this *(b)*, an obligation, investment unit, or element of an investment unit shall be treated as traded on an established securities market if it is so traded on or within 10 "trading" days after the date it is issued. "Trading" days shall mean those days on which an established

securities market is open. For purposes of this subdivision (iii), the term "established securities market" shall have the same meaning as in paragraph (d)(4) of § 1.453-3 (relating to limitations on installment method for purchaser evidences of indebtedness payable on demand or readily tradable).

(c) Determination of fair market value in cases to which (b) of this subdivision applies. In general, for purposes of *(b)* of this subdivision, the fair market value of property for which an obligation or investment unit is issued shall be deemed to be the same as the fair market value of such obligation or investment unit, determined by reference to the fair market value of that portion of the issue, of which such obligation or unit is a part, which is traded on an established securities market. The fair market value of such obligation or unit shall be determined as of the first date after the date of issue (within the meaning of section 1232(b)(3)) that such obligation or unit is traded on an established securities market. If, however, the obligation or investment unit is not part of an issue a portion of which is traded on an established securities market, but the property for which the obligation or investment unit is issued is stock or securities which are traded on an established securities market, the fair market value of such property shall be the fair market value of such stock or securities on the date such obligation or unit is issued for such property. The fair market value of property for purposes of this *(c)* shall be determined as provided in § 20.2031-2 of this chapter (Estate Tax Regulations) but without applying the blockage and other special rules contained in paragraph (e) thereof.

(d) Not in reorganization. An exchange which is not pursuant to a reorganization referred to in this subdivision *(d)* is an exchange in which the obliga-

tion or investment unit is not issued pursuant to a plan of reorganization within the meaning of section 368(a)(1) or pursuant to an insolvency reorganization within the meaning of section 371, 373, or 374. Thus, for example, no original issue discount is created on an obligation issued in a recapitalization within the meaning of section 368(a)(1)(E). Similarly, no original issue discount is created on an obligation issued in an exchange, pursuant to a plan of reorganization, to which section 361 applies regardless of the income tax consequences to any person who pursuant to such plan is the ultimate recipient of the obligation. The application of section 351 shall not preclude the creation of original issue discount. For carryover of original issue discount in the case of an exchange of obligations pursuant to a plan of reorganization, see subparagraph (1)(iv) of this paragraph.

(e) Effective date. Determinations with respect to obligations issued on or before May 27, 1969, or pursuant to a written commitment which was binding on that date and at all times thereafter, shall be made without regard to this subdivision (iii).

Treas. Reg. § 20.2031-2(f) (1958), T.D. 6296, 1958-2 C.B. 432, 480, 26 C.F.R. § 20.2031-2(f) (1982):

(f) *Where selling prices or bid and asked prices are unavailable.* If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

(1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and

(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" referred to in subparagraphs (1) and (2) of this paragraph are: The good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of any examinations of the company made by accountants, engineers, or any technical experts as of or near the applicable valuation date.

Office-Supreme Court, U.S.
FILED
MAR 7 1983
ALEXANDER L. STEVAS,
CLERK

No. 82-1297

In the Supreme Court of the United States

OCTOBER TERM, 1982

TEXSTAR CORPORATION, ETC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D. C. 20530
(202) 633-2217

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MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

In this federal income tax case, petitioner seeks review of the decision below denying its claimed deduction for interest allegedly paid to facilitate the exchange of corporate debentures for corporate stock. The decision turns on the particular facts and presents no legal question warranting review by this Court.

The pertinent facts may be summarized as follows: I.C.T. Discount Corporation was incorporated in 1952. Its name was altered to I.C.T. Corporation in 1955 and later changed to Unitex Industries in 1957. The assets of Unitex were purchased in 1966 by Texstar Corporation (Pet. App. 3a, 14a).

In 1952, I.C.T. had issued both common and preferred stock. The preferred was a cumulative, participating, no-par, non-voting stock with each share entitled to cumulative

dividends of 72 cents per year prior to the payment of any dividends on the common stock and then, if any dividend was paid to the common shareholders, to receive the same dividend per share that was paid to the common shareholders. On liquidation of the corporation, each share of preferred stock was entitled to receive $12 prior to any distribution on the common stock, with conditional participation in any subsequent distributions. The preferred stock was marketed door to door at $12 per share by salesmen who received 20% of the sale price as commission (Pet. App. 3a-4a).

During the early and mid-1950's, I.C.T. (later Unitex) experienced severe losses which resulted in a deficit in earned surplus in excess of $4 million. In 1956, new management took charge of the corporation and began a rehabilitation program. Though the new management began to produce profits, the weight of the accumulated deficit made the prospect of any dividend, even on the preferred shares, remote. With dividends on the preferred continuing to accrue but going unpaid, the prospect of any return on the common was more remote. To remedy this situation at least in part, management proposed to the preferred shareholders an exchange of three shares of common for each share of preferred. The preferred shareholders rejected this proposal (Pet. App. 4a, 14a-15a).

At a later meeting of shareholders, a resolution was passed directing the formulation of a plan to restructure the capitalization of Unitex in a manner satisfactory to committees of common and of preferred shareholders. Efforts in response to this resolution culminated in a plan to eliminate the entire class of 126,023 preferred shares and provide the preferred shareholders with $2 cash and a $10 debenture for each share upon its return. The debenture was payable in 20 years and bore interest of 5%. It was supported by a

sinking fund guaranteed to retire at least 2½% of the original number of debentures each year. The plan was presented and recommended to the preferred shareholders as one that would enable them to recover the original $12 which they had invested at the expense of their right to accrued but unpaid dividends. The plan, together with a contemporaneously adopted reclassification of the common stock, also had the effect of eliminating the earned surplus deficit from the corporate balance sheet (Pet. App. 4a-5a).

In this refund suit brought by petitioner in the United States District Court for the Northern District of Texas, petitioner sought a refund based on the theory that Unitex incurred interest expense of $8.01 for each share of preferred stock acquired from the debenture holders. The basis of petitioner's claim was as follows: It asserted that Unitex obligated itself to redeem each debenture ultimately at a cost far in excess of the fair market value of that debenture, deemed an equivalent to the value of property received in exchange. Thus, petitioner claims that the "package" which Unitex offered to procure each share of preferred stock, *i.e.*, a $10 debenture and $2 cash, exceeded the value of a preferred share received in exchange. In petitioner's view, the alleged difference between the $10 debenture and $2 cash on the one hand, and the fair market value of a preferred share on the other, was "interest," or "bond discount," charged by a preferred shareholder for entering into the exchange transaction. Because there was no separate market for the debentures (Pet. App. 9a), petitioner proposed that the fair market value of the debenture-cash package be equated with the fair market value of a preferred share. Once the latter value could be ascertained, petitioner argued that any difference in values is deductible interest or discount. Petitioner asserts that the value of a preferred share was $3.99

on the date of the exchange. Thus, it claims an interest deduction of $8.01 ($12 less $3.99) for each of the 126,023 preferred shares acquired via the debenture-cash package.

The district court upheld petitioner's claim (Pet. App. 23a-24a). The court of appeals reversed. Adhering to this Court's decision in *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974), the court of appeals concluded that the essential elements in the measure of bond discount were lacking in this case. As the court analyzed the transaction, there was no trading of preferred stock on any market to establish its fair market value. The $3.99 value proposed by petitioner was predicated on an estimate by an expert witness who, it admitted, "accorded little weight to the scattered quotations for the preferred on the over-the-counter market, because the market was too thin" (Pet. App. 9a-10a). In these circumstances, the court of appeals concluded that where the preferred shares were "redeemed *en bloc* pursuant to a plan approved by the shareholders [but 'opposed by a material minority of the preferred shares'], as in the insulated transaction in *National Alfalfa*," it was "unable to perceive in this artificial scenario the play of market forces acting through informed agents to reveal a measurable additional cost of borrowing money," which would be demonstrated where "market prices were available for either the debentures or the preferred" (Pet. App. 10a-12a & n.6).

1. The decision below correctly held that Unitex was not entitled to any bond discount deduction arising out of the exchange of its debentures and cash for the preferred stock. In *Commissioner* v. *National Alfalfa Dehydrating & Milling Co., supra*, the controlling decision on the question presented, this Court emphasized that "implicit in the concept of debt discount is the assumption, and indeed the requirement, that the transaction be subject to the exigencies of the competitive money market" (417 U.S. at 151).

The Court further noted (*id.* at 150) that "when a corporation issues to its preferred shareholders its own new debt obligations in exchange for outstanding preferred, the claimed fair market value of both securities is somewhat artificial since the exchange is effectively insulated from market forces by the intracorporate and private nature of the transaction." Thus, the Court denied an interest deduction for bond discount in *National Alfalfa* because neither the debentures nor the preferred shares were traded on an open market; "[a]ccordingly, the requisite evaluation of the property to be exchanged cannot occur in this intracorporate transaction and debt discount cannot be determined." *Id.* at 151.

2. Petitioner attacks the decision below on three grounds: (1) the preferred stock must be presumed to have some ascertainable value (Pet. 7-10); (2) the negotiations between the preferred and common shareholder are tantamount to market forces (Pet. 10-13); and (3) it is discriminatory to require trading on a national, published market (Pet. 13-17).

While the Unitex preferred stock probably had some value, it does not follow that such value is ascertainable with the precision necessary to sustain a deduction for bond discount. Indeed, in *National Alfalfa, supra*, 417 U.S. at 149, the Court refused, "[i]n the absence of any actual or even attempted sales of debentures or purchases of the preferred * * * in the open market, * * * to speculate as to what the market price and investor reaction * * * would have been" had the entire block of debentures and preferred shares been actively traded on the market.

Nor do the negotiations between the preferred and common shareholders support petitioner's claim because those negotiations were tailored only to return to the preferred shareholders their original $12 investment (Pet. App. 4a).

There is no evidence in the record that the relations between the preferred and common shareholders in this case were more instrumental in establishing the respective "values" of a debenture and a preferred share than were the relations between the preferred and common shareholders in *National Alfalfa*.

Moreover, petitioner mischaracterizes the scope of the decision below. The court of appeals only required, in accordance with *National Alfalfa*, that there be trading on some market to establish value (Pet. App. 9a). It did not insist, as petitioner suggests (Pet. 15 n.10), that there be trading on a national exchange. That holding is in accord with the Commissioner's position, quoted selectively by petitioner (Pet. 10), which stated that (quoting 81-1277 Appellant Reply Brief 5):

> We do not argue that the bonds and preferred shares must be traded on a national exchange before bond discount can arise, as Texstar suggests * * *. We note, rather, that some significant voluntary purchases of both securities by outside, unrelated parties must occur before value can be ascertained, and those purchases must establish more than the thin market that the Supreme Court in *National Alfalfa* held should be disregarded. * * *

Finally, as petitioner acknowledged in its brief in the court of appeals (Appellee Brief II), the decision is of diminishing administrative significance. Section 1232(b)(2) of the Internal Revenue Code of 1954 (26 U.S.C.), as added by Section 413(b) of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 609, determines the existence of original issue discount to a bondholder, and is effective with respect to bonds or other evidences of indebtedness issued after May 27, 1969 (other than evidences of indebtedness issued pursuant to a written commitment which was binding on

May 27, 1969, and at all times thereafter). Treasury Regulations on Income Tax (1954 Code), 26 C.F.R. 1.163-4 makes the same provisions applicable to the issuing corporation. Hence, this legislation resolves the question for debentures issued after May 27, 1969.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

MARCH 1983

DOJ-1983-03